

THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 343

DECEMBER 2001

Productive investors provide money that companies use to create real returns and real wealth. Successful productive investments are required to create real wealth. Parasitic investors buy financial assets. They don't know or care who gets their money, and the returns they seek come primarily from outside the company as phantom wealth. The drive to create phantom wealth hurts people, companies, communities, and society.

**Thornton Parker, *What If Boomers Can't Retire?*
Berret-Koehler Publishers, Inc., San Francisco, 2000**

HOW FAR DOWN?

Finally, it is now official that a recession is under way in the United States, having started in March. As usual, the National Bureau of Economic Research made the determination. The announcement neither surprised nor shocked anybody. Throughout the economy, the picture is gloomy, definitely much gloomier than the consensus had expected. But reflecting apparent unbridled faith in the wisdom of American policymakers and the resilience of the economy, the debate has already shifted from recession to the economy's impending recovery. Another plank in the short, mild recession scenario is the assumption that U.S. businesses have been unusually quick in correcting their former excesses.

More or less, it is now generally agreed that this is a different kind of downturn. Nonetheless, the consensus continues to project the customary short, V-shaped pattern of recession and recovery. With growing amazement, we note very little or no endeavor to explore the particular origin of this unfolding economic downturn. For us, this is the key issue to be painstakingly investigated because it gives us the clues for determining the length and depth of this recession.

Past recessions reflected little more than temporary inventory corrections. This one reflects a lot more. The hard truth that the consensus refuses to see is that the U.S. economy is in a post-bubble environment. The protracted credit excesses of the past have fueled not only a stock market bubble but in its wake a variety of unsustainable spending excesses that must be worked off. Manifestly, the consensus grossly underestimates the amount of time that this essentially takes. Above all, it has yet to notice that Corporate America is in the grips of an unprecedented profits crisis that is sure to worsen dramatically.

NO WALL OF WORRIES

Barely a year ago, the world's leading economic and financial organizations and most economists predicted that the U.S. economy would grow by 3.5% this year and by a similar rate next year. Just six months ago, the forecast for the two years was down to 1.7% for 2001 and 3.1% in 2002. The numbers for the third quarter put the year-over-year increase of U.S. real GDP at merely 0.8%. Considering that new data show an economy that is rapidly deteriorating right across the board, a final outcome of less than zero growth until year-end 2001 presently seems the best bet.

With recession now the generally accepted fact, the questions that have taken over as the hotly debated issue are how deep and how long it will be, and how robust will the following recovery be. What shape will the course of this downturn have — V, U or L? The fact is that the speed with which economic conditions are deteriorating in the United States has taken everybody by surprise, even most of the bears. Yet faith in the resilience of the

economy and the ability of policymakers to turn the economy promptly around again prevail. According to an old saying, bull markets rise on a wall of worries. No such wall is in sight this time.

The signs of optimism are everywhere. *Barron's* recently-published Big Money Poll found that two-thirds of the poll respondents described themselves as bullish or very bullish on the market's prospects through June 2002. It was the highest level of optimism the poll has seen in years. An incredible 84% of the institutional investors approved of Fed Chairman Alan Greenspan's job performance. The International Strategy & Investment group's poll of institutional investors has also found near-record levels of bullishness among professional money managers. The absurd result is that stocks are getting more and more expensive because profits have been falling much faster than stock prices. For Dow Jones stocks, the P/E ratio is up to 27 against 19 a year ago and from 27 to 37 for the S&P Index.

The general gross failure to recognize the approaching sharp economic downturn has clearly in no way dented the prevailing complacency. Nor do these people seem to see any reason to re-examine their badly flawed assessment. To think that the bursting of the biggest financial bubble in history, which fueled unprecedented excesses in borrowing and spending by consumers and enterprises, will be followed by the mildest recession in history reveals a truly frightening disregard of plain facts. But this disregard starts, of course, with the widespread blunder to mistake an overheating Bubble Economy for a healthy New Era Economy.

RECESSION DESPITE LOOSE MONEY

What exactly is unusual about this recession? Actually, it is significantly different on several counts. It begins with a striking difference in money and credit behavior. All past recessions had their obvious, immediate cause in a "credit crunch." The last recession, 1990-91, happened against the background of a protracted, sharp slowdown of private credit growth from \$632.5 billion in 1988 to \$187.1 billion in 1991.

As opposed to this experience, the present recession has been unfolding against the backdrop of unbridled money and credit growth. Instead of a credit crunch, there is a credit deluge. Since 1998, credit to the private nonfinancial sector has been expanding by more than one trillion dollars at annual rate. Yet the economy has abruptly stalled. Money growth keeps expanding at double-digit rates. This has no parallel in history. Manifestly, this recession cannot be explained as usual with tight money.

1990-91 was America's worst credit crunch in the whole postwar period. But why? Was the Fed particularly tight? In actual fact, there was clearly a lot more than just a tight Fed at work behind the credit crunch. Not just the banks, but the credit markets, too, were facing a huge shakeout from the prior financial excesses. Plunging commercial real estate prices set the pace. In February 1990, junk bond king Drexel Burnham Lambert went under, causing the \$200 billion junk bond market to seize up. Above all, the unfolding Savings & Loan disaster triggered a critical financial market assessment of the rosy asset price and economic assumptions underlying the 1980s' debt explosion. Clearly, the credit crunch had its cause in the fragility of the markets as much as in the fragility of the banks, for which one common thing was responsible: the boom and bust of the credit-financed real estate bubble.

It is a historical fact that no serious economic or financial crisis has ever come from tight money and high interest rates. Nothing is easier to reverse than this. Every depression or protracted recession has been preceded by extremely loose money which — through credit excesses — tends to bring about far-reaching dislocations.

What effectively retarded the U.S. economy in the early 1990s for several years was America's first encounter with the protracted, negative demand effects of a bursting asset bubble, which during the preceding years had stoked excessive commercial and residential building. This happened simultaneously and was even

more pronounced in several other countries, above all in Great Britain and Japan. In the United States, investment in residential and non-residential structures slumped steeply from 1988 to 1992, accounting overwhelmingly for the economy's slowdown. It was America's first recession in the whole postwar period that was not of the usual "garden-variety" inventory type. The prolonged slowdown that unfolded had its main source in slumping fixed investment in real estate, while industrial fixed investment held up unusually well.

Just as clearly, the present economic downturn in the United States is equally not of the garden-variety inventory type. Again it has its main source in slumping fixed investment, but of another pattern than in 1990-91. This time, the economic contraction is centered in plunging fixed business investment, while residential investment has held up exceedingly well. But while remaining at record levels, this is not enough to add to GDP growth. For that to happen, it needs rising building investment, and that is missing.

But the bubble of the late 1990s differs from that in the late 1980s in another most important way. Courtesy of far greater and far broader credit excesses, the U.S. economy is left with a far greater array of monstrous, structural imbalances — the massive current-account deficit, a record shortfall of personal saving, a worrisome build-up of corporate and consumer debt, and an unprecedented capacity overhang in manufacturing. In the late 1980s, the U.S. economy had a real estate bubble; in the late 1990s, the U.S. economy itself was the bubble. That's the key difference to all past recessions.

Speaking of the unusual major features of this U.S. economic downturn, housing definitely takes a particular place. In the past when a recession unfolded, it was always among the components that weakened first, simply due to its high sensitivity to interest changes. Presently, for the first time ever, it is the economy's main prop, apparently for the obvious reason that there never was tight money to have caused this recession. Putting it differently, the persistent housing bubble is compelling proof of persistent monetary looseness, past and present.

Most unusual furthermore is the peculiar mode in which the strong housing market has been propping up the economy. Oddly, it has not occurred through the usual channel of a significant rise in building activity, but rather through a monstrous surge in home-mortgage refinancing ("refis"), delivered by a hyper-efficient home loan industry. Inspired by increasing house prices and the lowest-ever mortgage rates, the frenzy of mortgage refinancing has been pouring billions of dollars into consumers' pockets. According to the Mortgage Bankers' Association of America, refis went from \$66 billion in the fourth quarter of 2000 to \$251 billion in the second quarter of 2001, providing a huge incremental injection to consumer purchasing power.

PUSHING ON A STRING?

There is more and more talk of whether or not the Fed is "pushing on a string," perhaps being caught like Japan in the infamous Keynesian "liquidity trap." In terms of credit and debt creation, the Fed's easing could not have been more effective than it actually has been. Total non-federal borrowing expanded in the second quarter of 2001 at an annual rate of \$1,250 billion, compared with \$1,165 billion in 2000 and \$1,169 billion in 1999. But the trouble is that the resulting credit and money deluge seems to flow everywhere, except into normal spending that hoists GDP growth.

It may, of course, be argued that the prevailing, extreme monetary looseness has prevented a much sharper economic downturn. It probably has. But how much more money and credit must be pumped into the economy to initiate an economic recovery? A Bubble Economy of such historic proportions apparently requires sustained, enormous credit injections merely to maintain the semblance of a normally functioning economic and financial system. It makes you think of the drug addict who needs ever-larger injections in order to merely postpone the painful withdrawal symptoms. We presume above all it is the grossly overextended financial system, built entirely on monstrous leverage, that absorbs the floods of money and credit. By the way, while the Bank of

Japan deliberately punctured their bubble with a series of rate hikes, the U.S. bubble has manifestly burst of its own accord.

We continuously read that there is no danger that the U.S. economy will follow Japan into a prolonged stagnation, because it is in a much healthier state than Japan was at the start of the 1990s. In our view, the truth is precisely the other way around. Measured by the key fundamentals of economic health, that is, investment ratio, savings ratio and balance of payments, Japan's economy was top fit at the time. But the credit excesses had badly dislocated its demand and output structures. Looking at these crucial aggregates for economic growth, the U.S. economy is sick to the bone. What's more, it has become hostage to permanent, rampant money and credit growth.

THE ROOT CAUSE: PROFITS CARNAGE

Now we come to the difference between the present U.S. recession and its precedents that we regard as the recession's root cause. It concerns the key investment incentive in a capitalist economy — profits. What has been attracting our attention more than anything else is the U.S. economy's unusually poor profits performance during the past few years. To find anything comparable, one has to go back to 1930, when profits fell almost 50% from the year before. It amazes us how little attention this outright profits disaster is finding in the macroeconomic discussion about the U.S. economy's prospects.

Trying to assess the profit performance, it is necessary to distinguish three distinctly different phases: *first*, three years of sub-par GDP growth from 1992 to 1995; *second*, five boom years from 1995 to 2000; and *third*, the economic downturn since the third quarter of 2000.

During the first phase, after-tax profits of nonfinancial corporations soared at an average annual rate of 17.5%, as against an average annual rate of real GDP growth of 3.2%. In the second phase, covering the famous years of *new era* growth, the pattern completely reversed. Real GDP growth accelerated to an average annual rate of 4.5%, while profit growth decelerated dramatically to an annual rate of 4.4%. As to the last phase since the third quarter of 2000, profits are down 28% at annual rate. What's worse, available data suggest a further sharp decline.

How does this compare with the profit performance in past recessions? As a rule, by the way, profits begin to decline before the recession starts. The recession of 1990-91 involved a 9.6% profits decline that occurred from the fourth quarter of 1988 to the fourth quarter of 1989. Its precedent was the double recession that had happened a decade earlier, lasting from the first quarter of 1980 to the fourth quarter of 1982: Profits in the nonfinancial sector fell altogether by 31.3% from 1978 to 1982. Manufacturing profits even fell a bit less. America's worst postwar recession happened between the fourth quarter of 1973 and the first quarter of 1975. It was accompanied by a prolonged period of broadly stagnating profits from 1968 to 1974, but without sharp declines.

As we have often stressed in the past, production in the capitalist economy is geared toward profits. The aim of all production is the pursuit of profits by businessmen. In the same vein, the expected rate of profit is the decisive inducement to invest. In recognition of this fact, we are keeping the performance and prospects of profits under close scrutiny.

Quoting John Maynard Keynes on this subject: “*We live in a society organized in such a way that the activity of production depends on the individual businessman hoping for a reasonable profit. The margin which he requires as his necessary incentive to produce may be a very small proportion of the total value of the product. But take this away from him and the whole process stops.*”

Assessing the U.S. economy's recent performance in this light has to start with the observation that profits fared rather poorly during the boom years of 1995 to 2000. According to national income data, overall nonfinancial profits for the second quarter of 2001 amounted to \$402 billion at annual rate. That virtually equals profits of \$403 billion recorded for 1995.

THE PROFIT MYSTERY

The bullish argument for the American profit miracle was that the alleged tech-driven acceleration in productivity growth would persist for years to come, leading to lasting, big gains in profit margins. This was the first erroneous assumption because productivity gains do not automatically accrue to business. Depending on conditions in the labor and product markets, they may be absorbed by lower prices or higher wages. We have argued all along, of course, for reasons explained, that there never was a productivity miracle in the first place.

As mentioned a bit earlier, we distinguish between three phases of the U.S. current business and profit cycle. As shown, the magnificent part happened between 1992-95, well before anybody spoke of a new paradigm economy. In actual fact, profits received their main boost during these years from a plunging interest rate bill and an unusual decline in depreciation charges. Our focus has always been on the second phase from 1995 to 2000 as the cherished new paradigm boom years, during which profits according to the national income data rose overall just 20%, while the Dow Jones and the S&P 500 more than doubled. Not to speak of the Nasdaq, which more than quintupled.

All this confronts us with three pertinent questions:

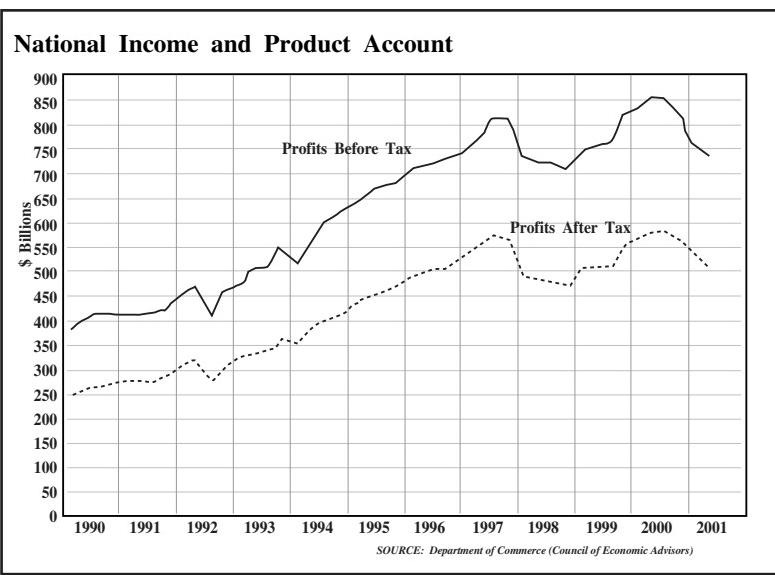
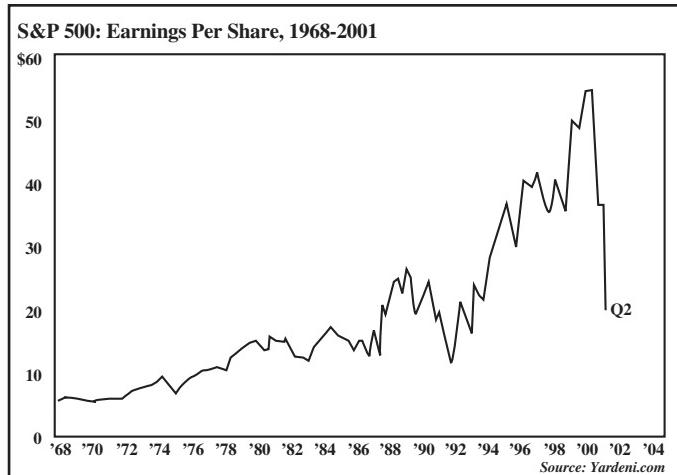
First, how could Wall Street impose the perception of a profit miracle that flagrantly contradicted the poor performance shown by the official National Income and Product Accounts?

Second, how do we explain this unusually poor profit performance?

Third, what is the further profit outlook?

As to the first question, the answer lies in the two charts to the right: the rise of aggregate earnings per share as reported by the individual companies, above, and aggregate profits as calculated and reported within the framework of the NIPA, below. Over the last five to six years, they have differed like day and night.

Notice that earnings per share more than quintupled between 1992 and 2000 from little more than \$10 to a peak of \$56. After 1997, the surge even turned vertical, while the government's NIPA figures went into a drastic slowdown. These phenomenal growth



rates of earnings per share supposedly justified the sky-high price-to-earnings ratios that the booming stock market delivered during the past few years. But the marvel was only in the quarterly corporate earnings reports. Official NIPA figures revealed a less than mediocre profit performance even before the downward revision of late July, considering that the economy was booming. How could the glorious perception of a profit miracle endure in the face of this preposterous incongruity in the available numbers? Very simple: Completely ignoring the dismal NIPA figures, analysts and investors had their eyes exclusively fixed on the heavily manipulated company-reported earnings.

Observing this gross discrepancy between the two sets of figures, we have been sounding alarm all along. Very few others took offense. Most probably, the great majority of economists, analysts and investors never noticed. For believers in the new paradigm economy, the trumpeted profit miracle was in perfect conformity with the trumpeted productivity miracle.

Remarkably, it's now the company-reported earnings per share that are taking the worst beating, being actually down by more than 60% against a year ago. Whopping write-offs and extraordinary charges to earnings are ravaging company-reported profits. All of a sudden, multi-billion dollar goodwill write-downs and restructuring charges are littering American and British corporate income statements. Goodwill in corporate balance sheets generally reflects the preposterous difference between the crazy prices paid for acquisitions in excess of the asset values shown in the books of acquired companies. Months ago, the Federal Accounting Standards Board decided to end the obligatory, gradual amortization of goodwill from the start of next year. Only when the assets lose value will they have to be written off.

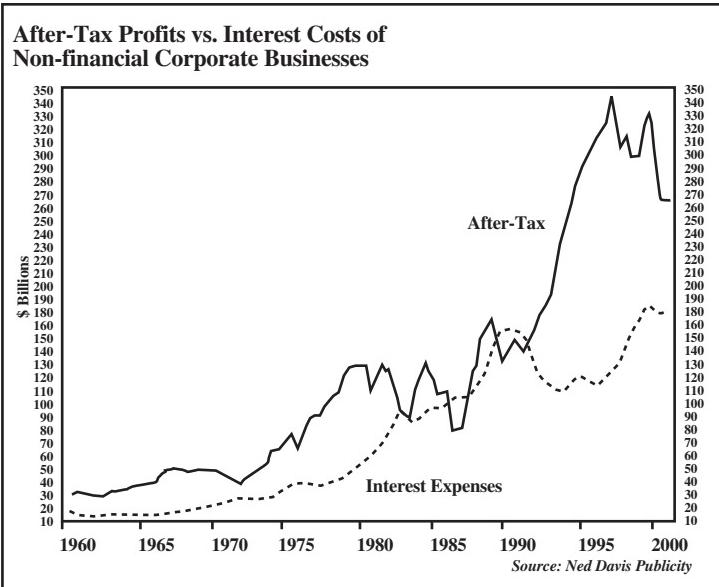
Could it be a sudden outbreak of honesty that is causing CEOs to act like this? Hardly.

First of all, in hindsight it is all too obvious that the accumulated goodwill is in most cases truly worthless, adding nothing to profits. But there may be a second reason for this rush to write off goodwill. Though it may appear crazy to make losses look even worse, it is helpful in reducing expenses and enhancing earnings next year and thereafter.

EBITDA NONSENSE

All of which inherently raises the question of the causal connection between today's huge write-offs and yesterday's glorious profit performance. Along with tame inflation, stellar productivity growth and low unemployment, outsized corporate profits were seen as one of the pillars of the New Economy that underpinned the stock market's bull run. This brings us back to the topic that we have been mulling for years — the ludicrous difference between the company-reported profit miracle and the NIPA-reported profit misery.

Of course, there is a direct connection between today's profit plunge and prior profit glory. In the past, massive deal making offered numerous opportunities for companies to generate phony financial profits that were sold as emblems of new corporate efficiency. In reality, a large and growing part of the company-reported profit bonanza had accrued directly or indirectly from gains in the stock market. As the bear market unfolded, this source of profit growth essentially dried up. The consequence is that desperate CEOs have to use ever more



aggressive tricks to hide the dismal profit truth. But the trouble is that the actual profits carnage is increasingly outpacing the tricks.

That has led to another widespread ploy in the presentation of the profit numbers. Giving proper information to investors would require comparing current profits with objective profits in the prior quarter or a year ago. But since this is sure to make for terrifying comparisons, a new measure had to be concocted that promises favorable comparisons. Corporations and market analysts found the convenient measure that offers unlimited possibilities to obfuscate investors — in *expected* profits that are slashed to such extreme lows that most comparisons come out as *better than expected*.

For example, on Nov. 14, Vodafone Group reported that for the six months to Sept. 30, its loss had soared to £9.7 billion, as against £4.8 billion in the year-ago period. Vodafone had, actually, accounted for the collapse in the value of prior investments, mainly Mannesmann, by over £10 billion. But the headline news in the press sounded very different: “Vodafone Beats Estimates as EBITDA Increases Sharply.” The ugly reality was an effective loss of £8.4 billion. But by excluding “earnings before interest, tax, depreciation and amortization,” the company turned the huge loss into a better-than-expected EBITDA-profit of £4.8 billion, up 46% from a year earlier. In happy response, investors instantly bid the shares up 6%.

A day later, the press reported that Hewlett-Packard’s “Earnings Beat Forecasts Amid Cost Cuts and Better-Than-Expected Revenue.” What had actually happened was that profits had plummeted 89%. But H-P said that excluding a \$282 million pretax restructuring charge for job cuts and other items, it earned 19 cents a share, as against an expected 8 cents. Revenue fell 18% to \$10.9 billion from \$13.3 billion. Since Merrill Lynch had predicted revenue growth of \$10.5 billion, this, too, was better than expected.

Why did corporate profit reporting slide into this mockery? The short answer is because the truth is much too ugly to be honestly faced by investors who have come to believe that they are investing in an economy delivering productivity and profit miracles. It has become a reckless game of systematic obfuscation of investors that knows no constraints in deceiving them and the public. The degree of deception has no precedent in history. Corporations exclude any expenses they want from the “pro forma” or “operating” earnings they trumpet in their news releases and conference calls, while playing down their miserable, actual earnings. Security analysts, typically reluctant to pick a fight with the companies they cover, readily pass on the same spin to investors.

EBITDA profits is the most common new formula. It may seem reasonable to regard interest rate costs and depreciation charges as costs that are not directly related to the core business of corporations, and therefore the EBITDA measure gives a better indication of the trend in underlying profitability.

Yet it is nonsense for an obvious reason. It has to be considered that the extraordinary rise of interest rate costs and depreciation charges among the expenses of U.S. corporations in past years has implicitly accrued from the specific strategies that U.S. corporations have pursued in their frenzied efforts to increase shareholder value in the short run through the acquisition binge, huge share buybacks and massive investment in short-lived high-tech equipment. It magnificently boosted profits per share in the short run, but its inherent flip side is, of course, that the soaring interest bill in the longer run is now hurting profits. As these costs are escalating, they cannot now be discarded as an expense unrelated to the core business.

DISMAL PROFITS PICTURE

We come to the most important question of all: What are the U.S. economy's profits prospects? Trying to answer this question, we look at the major influences on future profits: the probable development of

interest and depreciation charges on the one hand, and net corporate investment as a profit source on the other.

We begin with the question whether and to what extent the Fed's aggressive rate reductions will reach consumers and businesses. In general, it is apparently not appreciated that the ups and downs in the interest rate bill play a very important role in shaping business profits. During the first half of the 1990s, U.S. corporate profits received a tremendous boost from sharply falling interest rate expenses. Conversely, sharply rising indebtedness and higher interest rates sent the corporate interest bill soaring by \$142.9 billion, or 36%, during the second half of the decade. That compares with an increase in before-tax profits by \$176.9 billion, or 26%.

But wouldn't the Fed's furious rate cuts provide immediate, substantial relief in interest expenses, as it did in the early 1990s? Not necessarily. Fed policy acts upon the economy only indirectly through the banks and the markets, which do the actual lending to businesses and consumers. To what extent the Fed's rate cuts reach these borrowers therefore depends entirely on their positive or negative response. For the time being, this response appears rather negative.

The banks are equally hesitant in lending and in cutting their lending rates. More importantly, a far greater part of outstanding credit than in the past is tied to the fixed rates of longer-term corporate bonds. A sharp rise in credit spreads, acute weakness across the ever-larger junk bond market and the dramatic collapse in telecom debt rather suggest that the markets are not easing but tightening. And so has, of course, the stock market. Numerous firms with lower credit ratings have been forced to liquidate their cheap, short-term liabilities in the commercial paper market by tapping the much more expensive longer-term debt market. Therefore, don't mistake aggressive Fed easing for looser and cheaper credit for every borrower.

Talking of debt burdens, it is important to distinguish between two types of debt: productive and unproductive. Only credit that finances new plants and equipment is productive credit. It adds to the existing capital stock *that, in turn, earns the future debt service*. In other words, it is self-amortizing and self-financing debt. In essence, productive debt therefore does not rise exponentially. Only unproductive debt does.

By the same logic, the exponential rise of U.S. corporate indebtedness during past several years implicitly suggests its overwhelming use for unproductive purposes. Of these, two are particularly well-known: the acquisition binge and share buybacks. With an increase by \$1.8 trillion, or 63%, between 1995–2000, corporate borrowing went truly insane. This, by the way, compares with an increase by \$2.5 trillion over the prior 30 years.

Considering this unprecedented binge in corporate indebtedness, the perennial question to ask and to investigate is the specific use to which all that borrowed money was put. In other words, what was the counterpart to this eminent surge in liabilities on the asset side of corporate balance sheets? We identify three major components: *first*, a lot of worthless goodwill reflecting absurdly overpaid acquisitions, *second*, financial assets and, *third* — the smallest part of the three — increases in the tangible, productive capital stock. Expressing it in the terminology of Mr. Parker (see quote on page 1), trillions of dollars went into *parasitic investment*.

It is the essence of parasitic investment that it generates wealth and incomes outside the corporations and the real economy, adding nothing to current production and the stock of real capital wealth. While multi-billion amounts of dollars of worthless goodwill are now being written off, corporations remain stuck with compound interest on the associated debts.

Putting it differently, Corporate America is stuck with a mountain of unproductive debt. In the short run, the aggressive debt leveraging has magnificently helped to boost earnings per share, but its negative long-run consequence for the interest bill was clear right from the beginning. The long run of escalating compound interest is rapidly turning into the short run. It's not debt as such that spells later debt deflation but unproductive overindebtedness. Having stressed this point, Joseph Schumpeter wrote: "*The only conclusion that really follows is that the credit machine is so designed as to serve the improvement of the productive apparatus and to punish any other use.*"

THE CURIOUS CONUNDRUM

It has become the consensus view that the U.S. economy's key problem has been the bursting of the high-tech bubble. Plunging stock prices shattered confidence even before the destruction of the World Trade Center. All that is needed now for the revival of economic growth is to bolster consumer confidence and to restore their former willingness to borrow and spend. Lower mortgage rates, falling energy prices and tax rebates have combined to pump hundreds of billions into household buying power. For sure, the consumer has the means to keep spending. The consensus takes it for granted that his resilience is bound to prevent a deeper and prolonged recession. Worldwide, the U.S. economy's strong recovery early next year is a foregone conclusion. For most American economists the #1 issue for the economic outlook is what the consumer does.

We question the validity of this general obsession with consumer confidence and consumer spending for two reasons: Confidence and positive expectations, for sure, play an important role in economic decision-making. But in line with Professor Schumpeter, we hold the view: "*No great crisis has ever come about that was not fully explainable by the objective facts of the situation. Expectation, not so conditioned, never has produced more than short-lived spurts or breaks.*"

Scrutinizing the objective facts underlying the U.S. economy's downturn leads us to the conclusion that the widespread hopes for its speedy recovery are grossly misplaced. There is quite an array of objective facts that speak against it. Among them, the most obvious one is the collapse of business investment. In our view, the whole notion that most American economists subscribe to — that consumer demand, not business investment, drives the economy — is badly flawed. Capital spending by businesses is far more critical to economic performance than consumer and government spending.

This, essentially, raises the question of what were the decisive cause or causes of this investment recession. Generally speaking, they reside in the economic and financial imbalances that have built up from the borrowing and spending excesses of both consumers and businesses during the boom years. Essentially, these excesses have fueled unsustainable distortions in the economy's demand and production structure; that is, in the allocation of resources. U.S. stock prices skyrocketed to stratospheric levels. Stockowners were immensely enriched. But what really were the effects of this rapid, fabulous creation of financial wealth on the warp and woof of the underlying economy?

The acid test of any economic policy from a long-term perspective is its impact on investment resources and investment incentives. The available investment resources, setting the limit to net capital investment, are captured in the economy's net national savings as the pool of resources that is available for net investment. The key investment incentive is, of course, profits.

As to profits as the key investment incentive, the chart of NIPA profits on page 5 has already given the answer. It was the weakest profit cycle in the whole postwar period. Again, and overall, what we are witnessing in the United States is a corporate earnings crisis that has subsequently led to a capital-spending crisis.

CONSUMING CAPITAL

And what happened to investment resources, that is, saving and investment? As consumption persistently rose faster than GDP over the past couple of years, both were battered as never before. Inherently, the pressing consumer demand has pulled resources away from other sectors of the economy. In the actual U.S. case, this occurred plainly at the expense of net non-residential investment and net exports, and this essentially means at the expense of future economic growth.

It used to be common knowledge for thinking people that net capital accumulation is the key source and the benchmark of a nation's prosperity. It generates growth and wealth through four different effects: *first of all*, producing the capital goods creates jobs and incomes; *second*, the finished capital goods add to productive capacity; *third*, the new machinery tends to improve productivity; and *fourth*, the resulting factories and buildings represent the nation's true wealth.

Manifestly, rising stock prices involve not one of these effects. To the extent that they induce private households to lower their savings, as happened heavily in the United States, they effectively curtail the resources available for investment. What America has experienced in reality is massive capital consumption in the sense that consumption expanded at the expense of net investment. On the international front, the slide in personal saving has contributed significantly to the huge trade deficit.

From a macro perspective, therefore, rising asset prices don't create any wealth. Adding nothing to the economy's productive capacity, they are but phantom wealth. To the extent that they boost consumption at the expense of investment, they diminish real wealth creation and in its wake future growth. In the view of Friedrich Hayek, as explained in his book *Prices and Production*, "*a shift in demand from producers' goods to consumers' goods may cause a continued shrinkage of the capitalist structure of production and therefore prolonged stagnation.*" Generally speaking, a depression begins when the rate of net investment starts to decline (which in turn induces a decline in consumer incomes and consumer spending).

Manifestly, the U.S. economy is now facing two main dangers. One is that the capital spending crisis continues and deepens, and the other one is that the consumer, for one reason or another, will join the corporate retrenchment and return to a higher savings rate from current income. While highly desirable from a long-term perspective, it will spell disaster in the short run. For a prolonged recession, it is actually sufficient for the consumer to merely stop increasing his rate of dissaving, and that's already been the case for more than six months. Symptomatically, virtually all of the tax rebates ended in higher personal saving. Eventually, business retrenchment and consumer retrenchment are sure to cumulate.

A BIG, NEGLECTED NEGATIVE

It is the general view that the collapse in capital spending has its chief cause in prior investment excesses that have created a lot of idle, excess capacity. This perfectly conforms, of course, with the prevailing perception that the U.S. economy experienced its greatest investment boom of all times in the past few years.

As we have repeatedly stressed and explained, the greater part of this investment boom owed to the fact that American number crunchers, measuring economic growth, have been far keener than their counterparts in Europe to take into account improvements in the quality of goods, particularly in the case of computers. Absent this particular statistical seasoning, U.S. investment spending would have ranked as mediocre at best.

Pondering the causes of Corporate America's recent poor profit performance, we discovered another highly negative influence of great importance that is completely neglected: soaring business depreciation charges. During the early 1990s, their slow rise, reflecting low investment spending in the prior years, played an

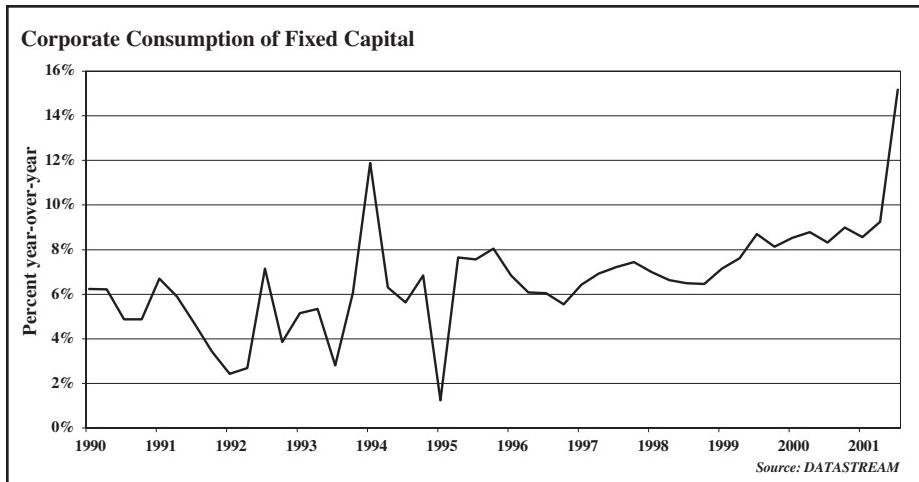
important role in boosting profits. This time, they loom large in the opposite direction. The proportion of capital consumption both to gross capital formation and gross domestic product has been swelling rapidly in the past few years, ravaging both corporate profits and net non-residential investment.

The underlying reason is a changing investment pattern. Because investment in longer-lived construction and machinery has increasingly given way to investment in short-lived equipment, above all computers and software, a rapidly growing proportion of gross investment each year represents replacement of existing capital stock rather than a net increase in its overall level. Putting it differently, more and more dollars of gross investment are needed to yield one dollar of net addition to the capital stock.

This caught our attention for two reasons. Soaring depreciation charges have hugely positive effects on measured GDP and productivity growth; in the same vein, however, they have hugely negative effects on business profits and the rate of net capital investment.

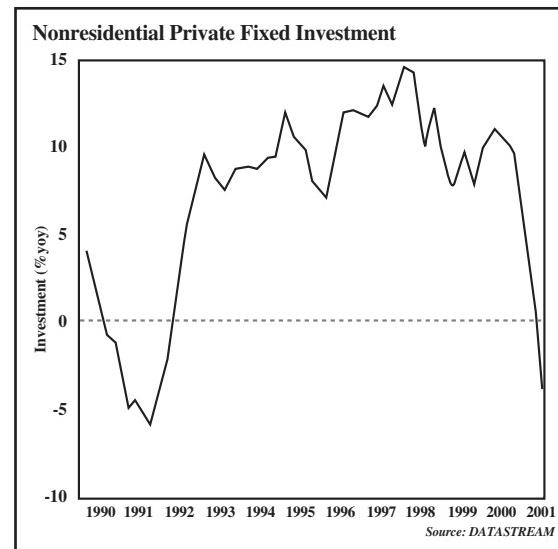
Although a growing share of capital investment simply replaces capital that wears out, the statisticians count it as an addition to GDP that, in turn, inherently adds to productivity growth by the same amount. Running currently at an annual rate of \$100 billion, the depreciation charges in 2001 have accounted for more than total GDP growth. If GDP were adjusted for depreciation, this would shave half a percentage point off productivity growth since 1995, cutting it from 2.4% to 1.9%.

Given this rapidly growing wedge between gross and net investment, a better measure of economic growth would be NDP (net domestic product = gross domestic product minus capital depreciation). NDP decreased \$0.6 billion to \$8,030.6 billion in Q1 '01 and further to \$8,011.9 billion in Q2. During the 12 months to the second quarter of 2001, no less than 40% of U.S. GDP growth accrued from the soaring capital consumption allowances.



THE KEY AGGRGATE: NET INVESTMENT

Strikingly, over the past few years the New Economy apostles in the United States, among them in particular Mr. Greenspan, have narrowly focused on the recorded rise in productivity growth as the key benchmark of the economy's new paradigm qualities. In line with traditional economic thinking, our attention is centered on *net fixed investment* in tangible assets — factories, machinery, offices, etc. — as the key source of long-term economic well-being. *First and foremost*, net fixed investment is the single most important factor in creating national wealth and productive power; and *second*, it is moreover the economy's most important profit source.



Measured by its net investment ratio, the U.S. economy definitely comes out as a high-consumption economy. Ever since the 1980s, it has a rock-bottom rate of net fixed, non-residential investment, hardly higher than in the crisis years of the 1930s, implying a low rate of economic growth in the long run. But there is a second effect to it that impacts the economy immediately and dramatically. That's the hugely negative effect on profits.

In past letters, we have repeatedly explained that net fixed investment — being the difference between gross investment and depreciation charges — is typically the largest and the most important profit source in a capitalist economy. The reason is that, from a macro perspective, it produces business sector revenue but no immediate expense because capital expenditures are capitalized. The expenses follow later and gradually with the depreciation charges.

By the same token, plunging capital spending means plunging profits, and vice versa, by the way. Over the three quarters from the fourth quarter of 2000 to the third quarter of 2001, non-residential fixed investment has slumped \$108 billion, and more of the same is most probably in the offing. Considering further that the depreciation charges of businesses are rising at an annual rate of more than \$100 billion, the two movements — slumping investment spending vs. surging depreciation charges — add up to the most savage profits carnage in the making. What's worse, the two trends are sure to continue.

Next year, something unprecedented and extremely negative will happen to U.S. non-residential fixed capital formation. As rising depreciation charges seem set to overtake declining gross investment spending, net fixed, nonresidential investment will turn negative. The last time this happened was in the Great Depression. The outlook is further clouded by the danger that the consumer will also retrench.

CONCLUSIONS:

Reflecting dramatic disruptions and catch-ups related to the terrorist attacks, there is a lot of “noise” in current U.S. economic data. Our focus remains strictly on corporate profits and capital spending as the most important influences determining the economy’s growth trend. As explained, they portend further drastic deterioration.

All things considered, it is us for a compelling conclusion that the U.S. economy is heading for a Japanese-style prolonged period of very weak growth, if not much worse. In the last analysis, it is being barely and precariously held upright by two bubbles that have yet to burst: the housing bubble and the dollar bubble. At the same time, a myriad of excesses in the financial system threaten to trigger a systemic crisis.

It is really a barrage of bubbles waiting for the shock to confidence that will burst them altogether. That shock to confidence is due when disappointing data will unravel the high-riding hopes for the coming U.S. economic recovery. For good reasons, the desire to see and to predict that recovery is pathological.

THE RICHEBÄCHER LETTER

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